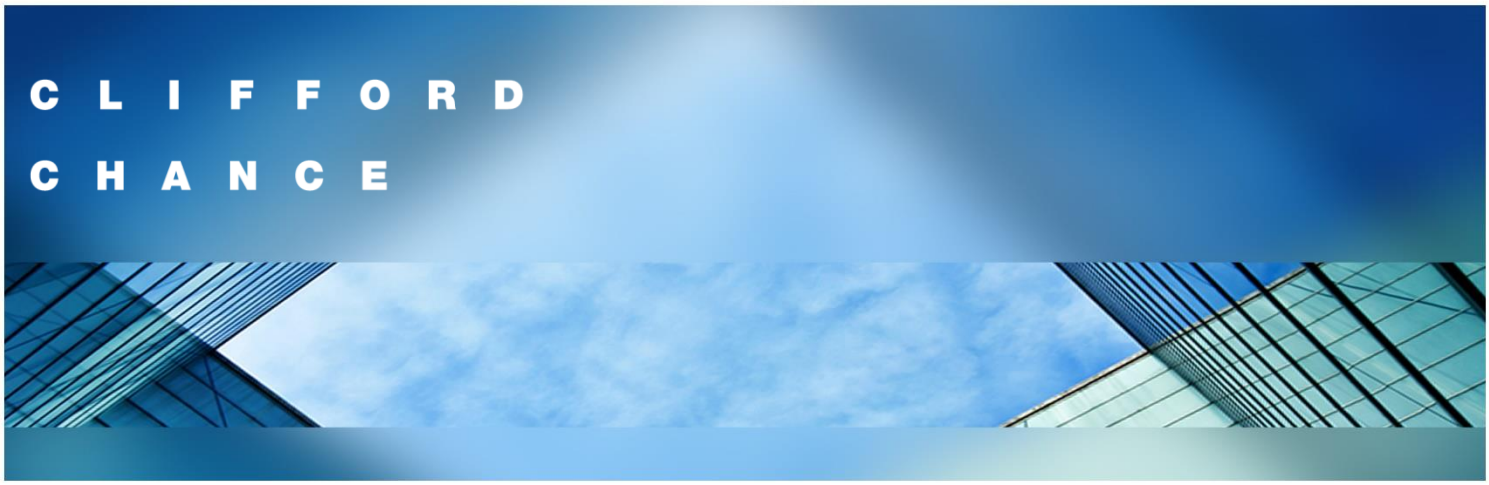

DEFENDING AGAINST U.S. TRADING-RELATED INVESTIGATIONS AND LITIGATION: DO THE U.S. SECURITIES AND COMMODITIES LAWS REACH FOREIGN CONDUCT?

Two recent appellate court decisions shed light on the limited circumstances in which regulators and private plaintiffs can pursue claims for violations of the U.S. securities and commodities laws for conduct occurring outside the United States.

Taken together, these decisions provide opportunities for persons defending securities and commodities actions involving overseas conduct to achieve an early and efficient favorable resolution. In order to take advantage of any such opportunities, a keen understanding of the territorial limits of the applicable laws will be critical. Persons subject to such actions would be well advised to seek experienced counsel who understand not only the applicable U.S. laws, but also the commercial realities of the markets in question, including the ways in which non-U.S. and U.S. segments of those markets interact.

Overview

In *Securities and Exchange Commission v. Scoville*, an appellate court allowed the SEC to pursue violations of the antifraud provisions of the Securities Act of 1933 (the "Securities Act")[1] and the Securities Exchange Act of 1934 (the "Exchange Act")[2] involving foreign purchasers of securities, because it found that the securities acts permit the SEC to pursue extraterritorial fraud actions. By contrast, in *Prime International Trading, Ltd. v. BP P.L.C.*, an influential appellate court blocked domestic plaintiffs from suing for violations of the Commodity Exchange Act (the "CEA")[3] arising entirely from defendants' overseas activity, because it found that this would be an impermissibly extraterritorial application of that statute.

Of course, each decision was rendered by a single federal appeals court. It remains to be seen whether other federal appellate courts will adopt—or depart

1 15 U.S.C. § 77(a) *et seq*.
2 15 U.S.C. § 78(a) *et seq*.
3 7 U.S.C. § 1 *et seq*.

from—the reasoning of these decisions, in future cases. Subject to those developments, however, these decisions suggest the following:

- The SEC and the DOJ have authority to pursue certain extraterritorial violations of the securities laws, provided the violations involve:
    - fraud; and
    - either wrongful conduct in the United States, or wrongful conduct outside the United States that has substantial effects within the United States;
- Neither the CFTC nor the DOJ has authority to pursue extraterritorial violations of the commodities laws (with the possible exception of violations involving swaps);
- Private plaintiffs can only sue based on domestic violations of the securities laws and the commodities laws, *i.e.*, violations committed within the United States (again with the possible exception of violations involving swaps); and
- A suit based on foreign conduct alleged to have "ripple effects" on U.S. markets will not likely be considered by courts to be a properly domestic application of the securities or commodities laws.

The *Scoville* Decision

On January 24, 2019, the Tenth Circuit Court of Appeals ruled that the SEC could maintain a civil enforcement action against an internet advertising company based in the United States, Traffic Monsoon, and its founder, Charles Scoville, based on allegedly fraudulent sales of securities to overseas purchasers.[4] Traffic Monsoon marketed package deals to its advertising clientele, which included (among other things) the option to share in Traffic Monsoon's revenues by viewing and clicking on advertisements and by recruiting new customers to Traffic Monsoon.[5] The SEC brought an enforcement action alleging violations of multiple antifraud provisions of the federal securities laws (namely, Sections 17(a) and 17(c) of the Securities Act of 1933 (the "Securities Act") and Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act")), arguing that Traffic Monsoon's revenue-sharing product is a security and that Traffic Monsoon operated as a Ponzi scheme.[6]

The SEC obtained preliminary orders freezing Scoville's assets, barring Scoville from continuing to run Traffic Monsoon, and appointing a receiver to operate Traffic Monsoon while the enforcement action was pending.[7] Scoville moved to set these orders aside, arguing, among other things, that the Supreme Court's decision in *Morrison v. National Australia Bank* prevents application of the antifraud provisions of the securities laws to offers or sales of securities to purchasers located outside the United States.[8] The appellate court disagreed with

4 *SEC v. Scoville*, 913 F.3d 1204 (10th Cir. 2019), *cert. denied*, --- S.Ct. ----, 2019 WL 5686461 (Nov. 4, 2019) (mem.).
5 *Id*. at 1210–12.
6 *Id*. at 1212.
7 *Id*.
8 *Id*. at 1214–15. In *Morrison*, the Supreme Court threw out claims brought by private plaintiffs against U.S. and foreign defendants for alleged fraud involving securities traded on foreign exchanges, holding that the Securities Exchange Act of 1934 does not apply extraterritorially. *Morrison v.*

Scoville, finding that the Securities Act and Exchange Act have extraterritorial effect for antifraud actions brought by the SEC.[9] The court's analysis relied upon a provision that was inserted into the Dodd-Frank Act just after *Morrison* was decided, which sought to restore the SEC's and DOJ's ability to pursue antifraud actions extraterritorially.[10] The provision in question modifies the Securities Act and the Exchange Act to provide U.S. courts with "jurisdiction" over actions brought by the SEC or DOJ for violations of the antifraud provisions of those statutes, provided the violations involve substantial "conduct within the United States" or a "foreseeable substantial effect within the United States."[11] In light of this change, the appeals court found that the SEC could properly bring a fraud action against a seller of securities to foreign purchasers where allegedly fraudulent conduct occurred in the United States.[12]

It is worth noting that the legislative "fix" upon which the *Scoville* court relied is limited in several important ways. First, it applies only to actions brought by the SEC and DOJ, so securities actions by private plaintiffs must still be "domestic" to survive a *Morrison* analysis. Second, it applies only to actions brought under the antifraud provisions of the Securities Act and the Exchange Act, so actions brought by the SEC or DOJ under non-fraud provisions of those statutes must likewise be "domestic" to survive a *Morrison* analysis. And finally, it applies only to the Securities Act and the Exchange Act; this legislative fix was not provided in Dodd-Frank for the CEA or the CFTC.

The *Prime International Trading* Decision

On August 29, 2019, the Second Circuit Court of Appeals affirmed a district court's dismissal as improperly extraterritorial of a class action alleging violations of the antifraud and anti-manipulation provisions of the CEA.[13] Plaintiffs, individuals and entities who traded crude oil futures and derivatives contracts, including on the New York Mercantile Exchange ("NYMEX"), sued several entities involved in the production of Brent crude oil in Europe's North Sea.[14] Plaintiffs alleged that

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Nat'l Austl. Bank Ltd., 561 U.S. 247 (2010). In reaching its conclusion, the Supreme Court applied a two-step test. In Step One, the Court considered whether the Exchange Act applies extraterritorially. The Supreme Court concluded that it does not, reasoning that statutes only apply extraterritorially when their text clearly provides for extraterritorial application, and that the Exchange Act contains no such clear statement. In Step Two, the Court considered whether the plaintiffs' allegations amounted to a "domestic" application of the Exchange Act. Here, the Court concluded that allegations regarding trading on foreign exchanges do not amount to a domestic application of the Exchange Act, finding that the Exchange Act is focused primarily on trading on U.S. exchanges and in U.S. over-the-counter markets. In reaching this conclusion under Step Two, the Court threw out the so-called "conduct-and-effects test," under which courts had permitted private plaintiffs and enforcement authorities to pursue violations of the securities acts involving securities offered or sold outside the United States when "the wrongful conduct occurred in the United States," or "the wrongful conduct had a substantial effect in the United States or upon United States citizens." Subsequent decisions make clear that *Morrison's* rationale applies with equal force to the Securities Act of 1933. *See, e.g., In re Vivendi Universal, S.A., Sec. Litig.,* 842 F. Supp. 2d 522, 529 (S.D.N.Y. 2012) ("*Morrison* permits Securities Act claims only 'in connection with the purchase or sale of a security listed on an American stock exchange, and the purchase or sale of any other security in the United States.'").

9 *Scoville*, 913 F.3d at 1215–18.

10 *Id*. at 1215 (citing Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 929P(b) (incorporated into the Securities Act at 15 U.S.C. §§ 77v(c), and the Exchange Act at 78aa(b)).

11 While the *Scoville* court found that Dodd-Frank amendments to the securities acts gives those statutes *some* extraterritorial effect, it is conceivable that other appellate courts could decide this issue differently. The Dodd-Frank amendments refer to the "jurisdiction" of U.S. courts. However, the Supreme Court in *Morrison* made clear that the question of extraterritorial reach was one of Congressional intent, and *not* jurisdiction. Because the Constitution allows for extraterritorial application only when "clearly expressed" in a statute (*Morrison*, 561 U.S. at 255 (citing *EEOC v. Arabian American Oil Co*., 499 U.S. 244, 248 (1991)), a future court could conclude that the mistaken invocation of "jurisdiction" in the Dodd-Frank amendments is insufficient to confer extraterritorial reach.

12 *Scoville*, 913 F.3d at 1219.

13 *Prime Int'l Trading, Ltd. v. BP p.l.c.*, 937 F.3d 94 (2d Cir. 2019), *reh'g and reh'g en banc denied*, No. 17-2233, Dkt. No. 272 (2d Cir. Oct. 16, 2019).

14 *Prime Int'l Trading*, 937 F.3d at 98–100.

defendants had traded physical Brent crude in Europe in order to manipulate an important Brent crude benchmark, the Dated Brent Assessment, with the goal of benefitting their own physical Brent positions and related futures positions, including on NYMEX.[15] The Dated Brent Assessment is factored into the price of futures contracts traded on ICE Europe, an exchange located outside the United States that lists the most actively traded Brent futures contract (where plaintiffs also claimed to have transacted).[16] The price of the futures contract on ICE Europe, in turn, is factored into the price of the Brent futures contract traded on NYMEX.[17] Plaintiffs alleged that defendants' manipulative trading of physical Brent crude in Europe harmed them by impacting the price of their NYMEX Brent futures.[18]

The Second Circuit first recognized that its own precedent had previously applied the logic of *Morrison* to conclude that Section 22 of the CEA, which creates a private right of action, does not provide for extraterritorial application.[19] The court further concluded, for the first time, that neither the antifraud nor the antimanipulation provisions of the CEA cited in plaintiffs' complaint (namely, CEA Sections 6(c)(1) and 9(a)(2)) apply extraterritorially.[20] On that basis, the court next considered whether the plaintiffs had alleged a domestic violation of the CEA. Assuming (without deciding) that plaintiffs' alleged trades on NYMEX and ICE Futures Europe constituted "domestic transactions," the court expanded on Second Circuit precedent interpreting *Morrison* in the securities context to conclude that a properly domestic application of the CEA requires plaintiffs to plead not only domestic transactions, "but also domestic—not extraterritorial—*conduct* by defendants that is violative of a substantive provision of the CEA."[21] Although plaintiffs had alleged that their domestic purchases were harmed by defendants' allegedly manipulative trading in Europe, the court concluded that such "ripple effects" were insufficient to render the alleged violations domestic. Because defendants had allegedly acted outside the United States to manipulate the price of Brent crude cargoes that were also located outside the United States, plaintiffs' claims were "so predominantly foreign as to [be] impermissibly extraterritorial."[22]

The Second Circuit's ruling is potentially sweeping in impact: it makes clear that overseas conduct will not give rise to a domestic violation of the CEA. The *Prime International Trading* ruling thus casts doubt on some of the CFTC's and DOJ's more aggressive assertions of authority to regulate overseas conduct. For example, the CFTC and DOJ resolved investigations with multiple panel banks involving alleged attempts to manipulate foreign benchmarks such as LIBOR. Some of these matters appear to have been based on allegedly manipulative conduct occurring entirely outside the United States and predominantly affecting futures and derivatives traded outside the United States. The CFTC's and DOJ's ability to bring similar actions in the future may be impaired by this decision.

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15 *Id*. at 100.
16 *Id*. at 99.
17 *Id*. at 100.
18 *Id*.
19 *Id*. at 103.
20 *Id.*
21 *Id*. 105 (emphasis in original).
22 *Id.* at 107 (internal quotations omitted).

Indeed, the CFTC filed a strongly-worded amicus brief in *Prime International Trading*, arguing that "using cash-market transactions or disseminating false information" are common methods of manipulating exchange-traded derivatives, and that "[i]t makes no difference" under *Morrison* "if those actions occurred overseas."[23] Citing USD LIBOR and other settlements, the CFTC emphasized that "manipulation from outside the United States is a frequent target of CFTC enforcement actions,"[24] and argued that a decision affirming dismissal could have "negative consequences" for its enforcement regime.[25] Yet the Second Circuit was not persuaded by those arguments, instead affirming that CEA Sections 6(c)(1) and 9(a)(2) require domestic conduct, and dismissing plaintiffs' claims because they had pleaded "no allegation of manipulative conduct or statements made in the United States."[26]

Of course, the CFTC could seek to avoid the impact of *Prime International Trading* by pursuing enforcement actions in federal district courts outside of the Second Circuit. And even in the Second Circuit, a court might also reach a different conclusion in a matter involving swaps, as Dodd-Frank amended the CEA to provide that its swaps provisions:

> shall not apply to activities outside the United States unless those activities – (1) have a direct and significant connection with activities in, or effect on, commerce of the United States; or (2) contravene such rules or regulations as the Commission may prescribe . . . to prevent the evasion of any provision of [the CEA].[27]

In light of these recent judicial developments, targets of any such actions must understand both the territorial limits of the applicable laws and the extent of any U.S. or foreign conduct, in order to take advantage of any possibility of an early resolution that these decisions may present. Please contact your Clifford Chance Partner if you wish to know more about this subject.

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23 Br. for Amicus Curiae CFTC at 22-23, *Prime Int'l Trading,* No-17-2233, Dkt. No. 148.
24 *Id.* at 23.
25 *Id.* at 4.
26 *Prime Int'l Trading*, 937 F.3d at 107-08.
27 7 U.S.C. § 2(i). It remains to be seen whether courts will conclude that this section amounts to an "affirmative intention of the Congress clearly expressed," sufficient to give the swaps provisions of the CEA extraterritorial effect. *Arabian American Oil Co*., 499 U.S. at 248. However, the *Prime International Trading* court suggested in *dictum* that this language suffices to concur extraterritorial jurisdiction. *See Prime Int'l Trading*, 97 F.3d at 103 ("Section 2(i) . . . shows that Congress 'knows how to give a statute explicit extraterritorial effect and how to limit that effect to particular applications' within the CEA" (quoting *Morrison*, 561 U.S. at 265)).

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